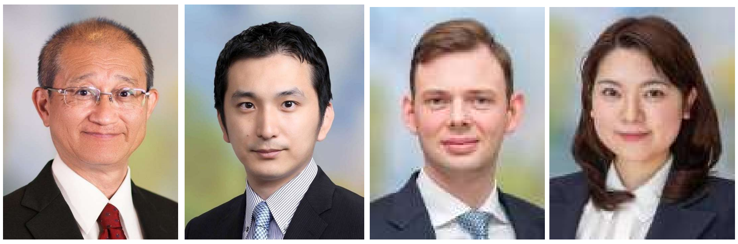
Decarbonized Energy Funds Focused on Overseas Investment

Naoaki "Nick" Eguchi
Seiji Tomimoto
Michaël Tiralongo
Akiko Tsuji
(From left to right)
Baker McKenzie, Tokyo



1. Decarbonized energy fund focused on overseas investment: establishment and asset acquisition

Baker & McKenzie (Gaikokuho Joint Enterprise) recently advised Japan Energy Capital G.K. on the acquisition of overseas renewable assets in relation to the establishment of Japan Energy Fund (the "Fund"), a decarbonized energy fund focused on overseas investment. Japan Energy Capital G.K. will serve as the general partner of the Fund, with ENECHANGE Ltd., Looop Inc, Daiwa Energy & Infrastructure Co. Ltd., and Hokuriku Electric Power Company as first investors. The Fund aims to finance a pathway to building sustainable societies setting five Sustainable Development Goals (SDGs) at the core of its investment policy. By recruiting investors within Japan and overseas to invest in decarbonization and ESG projects, it aims to generate approximately JPY100 billion in investment.

The Fund first plans to acquire joint operating rights to a 13 MW solar power plant in the Republic of Turkey — an emerging market where electricity demand is expected to grow steadily and where the renewable energy market investment environment is improving — for USD10 million (JPY1.1 billion). The power plant went into operation in May 2018 and will benefit from a feed-in tariff of approximately USD 13.3 cents for 10 years.

The project was led by Naoaki "Nick" Eguchi, partner and co-chair of the Renewable & Clean Energy Group at the Baker McKenzie Tokyo office. Seiji Tomimoto, a senior associate with experience working in Istanbul, collaborated with Baker McKenzie Istanbul office partner Duygu Turgut and senior associate Güven Maviç on this project.

2. Growing demand for infrastructure funds

Supported by the adoption of the SDGs at the 2015 United Nations Summit, investment in renewable energy by companies and institutional investors has been accelerating in recent years. According to a note released by the United Nations Environment Program (UNEP) Bloomberg New Energy Finance and the Frankfurt School-UNEP Collaborating Centre, renewable energy investment in 2019 amounted to US $ 282.2 billion[*], more than half of which was directed to developing countries. Outside Japan, there is an increasing

Solar power plant in Denizli Province, Republic of Turkey Power generation capacity 13.514 MW

[*] https://www.reuters.com/article/us-renewables-investment-idUSKBN23H281

momentum to invest in renewable energy assets and cutting-edge energy technologies through infrastructure funds.

Many infrastructure funds are organized in Luxembourg or the Cayman Islands, where tax incentives are available. The formation process itself is not significantly different from that of a general fund, however there is a variety of ways in which unlisted infrastructure funds can be structured, especially in light of some of the differing features of infrastructure assets.

This article will examine the most commonly used structures for infrastructure funds, namely (A) funds that closely follow the private equity model, (B) funds that follow the private equity model but have longer terms and (C) funds that have a greater focus on income yield, and was written with the help of Baker McKenzie lawyers specialized in investment funds, including Jason Ng (Hong Kong), Michael Kunstler (Sydney), Lewis Apostolou (Melbourne) and Laurent Fessmann (Luxembourg).

A. Private equity infrastructure funds

The majority of infrastructure funds closely resemble most other private equity funds from a structuring perspective. These "PE-Model Infra Funds" have a 10-year term and are focused on boosting the returns of the fund primarily through the increase of capital growth on exit. Accordingly, the performance fee of a PE-Model Infra Fund is structured in the same way as in private equity funds, through carried interest. Carried interest provides the management team of the fund with a share of the overall profits of the fund after investors have had their invested capital returned to them, and the fund has achieved a pre-determined investment return, (the "hurdle"). Like in private equity funds, it is most common for PE-Model Infra Funds to have a hurdle set at 8% per annum and a carried interest of 20%. However, in PE-Model Infra Funds, there is sometimes a lower hurdle rate, particularly for lower-risk strategies, like core brownfield funds, where the hurdle may fall to 5-6% to accommodate the lower projected internal rate of return ("IRR") of these funds.

In relation to management fee, there are also quite strong similarities between PE-Model Infra Funds and private equity funds. As in private equity, during the investment period of a PE-Model Infra Fund, management fee is typically charged on total committed capital to that fund. Following the investment period, there is what is commonly known as a "step down" on the management fee, with a potential reduction in the management fee rate and more commonly a reduction on the base on which the management fee is charged. The base changes typically from total investor commitments to the acquisition cost of unrealised investments. Generally, management fee rates tend to be lower in PE-Model Infra Funds (between 1.25 to 1.75% per annum) than in private equity funds, in part due to the larger size and the lower IRR of PE-Model Infra Funds.

B. Long-term and extension private equity infrastructure funds

Alongside PE Infra Funds, taking up a much smaller proportion of the market are long term PE Infra Funds. These funds may either: (a) begin with a longer term (typically in the region of 15-20 years) ("**Long Term PE Infra Funds**"); or (b) have a ten-year term, but the fund documents incorporate the option to extend the fund term for periods of 5 to 10 years ("**Extension PE Infra Funds**"). For both types of funds, the key issues are incentivizing the management of the fund and providing liquidity to investors.

In Long Term PE Infra Funds, the holding period of the asset will often span both (i) the construction and development stage; and (ii) the operation stage. To provide a private equity style incentivisation to management, the fund documents may provide for a carry crystallization event earlier on in the life of the fund, around the 8-10 year mark. A carry crystallization event does raise issues as to how the unrealized asset is valued and how and when the carried interest from the unrealized assets will be distributed. Such issues are typically solved by way of independent third-party valuation. Often the crystallized carried interest is structured to be distributed to the fund manager in priority to distributions to investors. In such arrangements, the fund manager will usually be required to reinvest a portion of the carried interest received from a carry crystallization event to ensure ongoing alignment of interest with the investors.

At the time of the carry crystallization event, investors may be given the opportunity to terminate the fund with the vote of a super majority of investors or, if this option is not chosen by the investor body, the fund manager may arrange a secondary program (i.e., a sale of these investors' interests to existing or new investors) to assist investors exit their investments. In Long Term PE Infra Funds, there may be a second step down in management fee around the 7-10 year mark, and this may be connected to any carry crystallization event. This further step down in management fee reflects that the fund is moving to its operation stage, where the time commitment of the fund manager is further diminished.

Extension PE Infra Funds bear a number of the hallmarks of a Long Term PE Infra Fund. Like in a Long Term PE Infra Fund, the investors are given an opportunity to have their say through a vote of the investor body to determine what happens to the fund at the 10-year mark. Similarly, to help investors make such determination, the manager arranges for the portfolio of the fund to be valued. If the investors agree to extend the life of the fund, then a carry crystallisation event takes place in much the same way as for Long Term PE Infra Funds, with the related issues of valuing unrealised assets and continued alignment of interest (as discussed earlier). Like with Long Term PE Infra Funds, the manager will also often arrange for some form of secondary program to assist those investors who wish to exit their investments, in this case as a result of a fund extension (as opposed to a fund continuation in the case of a Long Term PE Infra Fund). The management fee and carried interest structuring in an Extension Fund also often matches that found in a Long Term PE Infra Fund.

As we have seen from the preceding paragraph, there are a lot of similarities between a Long Term PE Infra Fund and an Extension Fund. The reasons why one is chosen over the other are more about the relative level of control each party has in determining whether the fund will continue past the 10-year mark. In short, due to how the investor voting mechanisms are constructed, it is more likely that a Long Term PE Infra Fund would enjoy the second decade of its term than an Extension Fund.

C. Income-driven infrastructure funds

Some investors prefer to commit more of their allocation to infrastructure funds, which are focused on consistent low-risk, stable income yield investments ("**Income Driven Infra Funds**").

An Income Driven Infra Fund is structured with a focus on providing a stable income yield to investors over a long period of 25-30 years, with less attention paid to the capital return of the assets. The performance fee is structured around the manager's ability to outperform a "hurdle" focused on income yield, which is typically set around 5-7% per annum (depending on the level of risk of the fund's strategy). Each year, if the fund achieves the hurdle, the manager receives typically between 10% to 20% of the net cash flows above the hurdle. A shortfall mechanism is also incorporated so that if, on previous years, the fund has not achieved the relevant hurdle, the investors will recoup such amounts in addition to the hurdle for that year before the manager receives its performance fee.

Management fees earnt by fund managers of Income Driven Infra Funds tend to be lower than PE Infra Funds, as Income Driven Infra Funds tend to require less active management of the assets and the anticipated returns of the fund are typically lower. During the investment period, the base on which management fee is calculated will be smaller, in particular if the manager is slow off the mark to invest capital. Following the end of the investment period, the step down can be quite significant, falling sometimes to a rate of 0.5%-0.75% per annum.

3. Fund formation

Along with the above considerations regarding the nature of the fund (degree of involvement of the investors in asset selection, length of fund period, etc.), several factors must be taken into account before deciding of the jurisdiction of incorporation of an infrastructure fund, such as the regulatory environment (frequency of regulatory reporting, marketing restrictions), the degree of contractual freedom, the reliability of dispute resolution mechanisms, freedom of transfer of funds, thorough corporate governance and trustee liability, form of incorporation (company or limited partnership), limitations on investor liability (e.g. whether concepts such as "piercing the corporate veil" exist and are easily recognized), as well as tax considerations (pass-through taxation, tax treaties on withholding tax and capital gains between the jurisdiction where the investors are located, the jurisdiction where the assets are located and the jurisdiction of incorporation of the fund, and taxation on managers' compensation). In particular, for long-term funds such as infrastructure funds, it is important to have a stable legal system and tax incentives on which the fund may rely for the long term. An overview of the history of fund formation shows that there are also changes in jurisdictions of formation. In recent years, the Luxembourg limited partnership has become a popular vehicle for infrastructure funds.

In some cases, additional business entities are set up above and below the main fund to build a structure adapted to the characteristics of the targeted assets. In that case, it is necessary to consider non-recourse financing structures similar to those commonly used in project finance or acquisition finance for the construction and acquisition of infrastructure assets, in order to block any potential claims from creditors of these additional business entities.

It takes a lot of time and money to restructure a fund once it has been formed, and there is always a risk of being exposed to unexpected taxation after the restructuring is completed. It is therefore essential to receive appropriate structuring advice from legal and tax experts at the time of fund formation.